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INVESTMENT SELECTION & REVIEW ISSUE

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INVESTMENT SELECTION: WHY MERGER DEALS ARE SCARCE - AND HOW TO SPOT CANDIDATES

Few stock groups hold the merger/acquisition allure of realty trusts.

Many trust stocks sell at handsome discounts from a book value that appears sound and stabilizing.

And their capital base and asset size have shriveled so much that outsiders assume this will force realty trusts to consolidate or merge into non-REITs.

That's the classical way of rebuilding a depleted equity base.

And rebuilding equity is essential because it has been cut two ways:

First in nominal dollars: Shareholders' equity has been cut in half, from \$5.8 to \$2.8 billion over the four years through 1977.

Second, in real dollars: Inflation has eroded the buying power of the equity base by another 50% in that same span, so that the smaller dollar base really represents about one-fourth of 1973 purchasing power.

Hence the theory of outsiders: only new and larger entities, freed from the sins of their fathers, would be able to raise new capital and rebuild equity.

Worse, administrative costs are also going up, raising the cost of running a public company -- whether large or small.

For a small public trust, this means the cost of lawyers, accountants and other administrators to comply with S.E.C. rules is rising.

But invested assets are falling at the same time, boosting expenses as a percentage of assets.

In the REIT peak years of 1971-72, this total G&A load including fee to an external investment adviser seldom exceeded 1½% of average invested assets.

Now expense ratios of 2% are becoming common and 2½-3% ratios are popping up.

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These higher expense ratios plus higher interest rates have the side effect of throwing many trusts into negative leverage.

Lest you think negative leverage isn't important to you as an investor, consider:

If a trust earns 10% gross operating income after direct expenses on a property investment and has to pay 2% of assets as expenses merely to sustain itself, your total return is automatically cut by 20%.

One little noticed result is that leverage on borrowed funds has turned negative for many trusts. This means that a mortgage trust paying banks $11\frac{1}{4}\%$ for new short-term money (125% of the prime rate) has to earn something like $12-3\frac{3}{4}\%$ minimum on its mortgage investments just to break even after administrative costs.

A property trust paying $9\frac{1}{2}\%$ or more for mortgage money faces the same arithmetic.

This negative leverage is one reason viable, dividend paying trusts still have sub-par return on book value -- $6\frac{1}{2}\%$ average for both property/mortgage and long-term mortgage groups in our latest monthly computer survey (RTR, July 28, p. 3).

Now all this may seem very remote to the investor trying to pick merger or acquisition candidates from among realty trusts.

But it's really vital.

For the plain fact is that return on book value ranging from $6\frac{1}{2}\%$ to $9\frac{1}{4}\%$ for viable dividend paying trusts is sub-par compared to industrial companies.

Industrial companies have earned about 12% after taxes on their shareholders' equity in recent years, and returns over 15% aren't uncommon.

Since qualified trusts don't pay Federal income taxes, their low pre-tax return suffers by comparison.

With that low performance record, you'd think realty trusts would be rushing into mergers that held some hope of giving shareholders a decent return.

Especially since the corporate appetite for mergers has been unprecedented during the past year or so.

Deals running over \$100 million have become commonplace; three years ago they were rare.

They result because depressed stock prices have whetted the corporate urge to merge.

But realty trust stock prices have been equally as depressed -- against the backdrop of soaring market prices for individual properties.

Couple that with anemic internal return and you can understand why a recent REIT management conclave was described as "100 managers trying to decide whether to sell out and give the money back to the shareholders, or try something new."

So far, there have been few overt merger/acquisition moves or actions to use the industry's enormous net operating loss (NOL) tax benefits (RTR, June 9).

And that's the heart of today's opportunities to capture that discount -- without being involved in the merger directly.

Because when operating return on book value is low compared to industrial companies, the real attraction for merger partners is to capture the discount between current market price of the shares and the sell-out value of the properties.

That's why takeover talk is in the air -- and why some outsiders think some trusts are worth more dead than alive.

Hence merger means submerger and going out of business for most realty trust managers.

So it's no wonder that many realty trusts have taken elaborate steps to fend off unwanted takeover overtures, large block purchases, and anything else they view as the work of "raiders" or unfriendly speculators.

Some are telling less and less about their properties. A few have staggered terms of their trustees so shareholders can't elect a full new board at once.

In a few instances, they've done battle in court with dissident shareholders. C.I. Realty waged a lengthy court fight with entities of Maurice Clairmont that ended in May when Clairmont's company lost and sold its shares to the trust's adviser.

United Realty in May sued in Federal court to bar Federated Reinsurance Corp., its parent Federated Development Co., both of Houston, and their chairman and president Charles E. Hurwitz from adding to the 278,000 or 10.7% of URT shares now owned.

Hurwitz, incidentally, last week took a board seat at McCulloch Oil Co. after that company too had sued to block additional purchases.

All this means that stock control is the true test for spotting potential merger/acquisition and even liquidation candidates.

And trusts and/or advisers are becoming increasingly involved in that scramble.

C.I. Realty's adviser, C.I. Planning Corp. and City Investing subsidiary, bought 354,370 sh. or 13.6% of shares in open market and block purchases through May 23, 1978.

Two other unrelated groups hold 484,000 sh. or 18.6% of CIX shares.

And Investors Realty Trust bought 100,000 sh. from the parent of its former adviser, Thomson McKinnon Securities, in June 1978, when the trust became internally administered. The price was about 7½.

But other trusts are also coming in for heavy block buying. Recent buyers:

--Buffalo stockbroker Brent Baird has initiated or expanded holdings in Kentucky Property., Citizens Growth Props., and Texas First Mtg.

--Palo Alto, Cal. investor Morse F. Van Horn reports new positions in Builders Investment Group and Lincoln Mtg.

--Oklahoma City stockbroker E. Peter Hoffman Jr. has expanded holdings in Midland Mortgage Inv. to 13.2%.

--An interesting double play in which Lee Gray, president of J.K. Lasser Tax Institute, Inc. has acquired 19.3% of Transco Realty Trust, a small property trust, and Transco in turn has bought 15.6% of Hospital Mortgage Group shares.

A complete rundown of major block holdings as reported most recently appears at the top of page 4.

You can use this list two ways to shape your investment program:

Buy stock on the list. It's simple: every one of the persons or groups named in the list has signalled a fairly large monetary commitment to the stocks named.

Sometimes management isn't too happy with that expressed interest.

And sometimes more than one group is competing for large blocks. In most instances they'll drive prices higher with their bidding. Two groups are in C.I. Realty.

And management may get into the act, as did C.I. Realty's adviser already. This may be one reason C.I. Realty is today trading near its 1978 high.

So our list shows two groups buying into Fidelco Growth (2-3/4 ASE) and Lincoln Mortgage (2-5/8 bid OTC). If they start competing, outside investors could profit.

Or buy stock not on the list. Reasoning here is simple too:

Stock on the list have already been spotted by someone and their buying may have moved the price up sharply. The Atlanta National buyers for instance began buying near \$2/sh.; the price is 5 bid now.

So concentrate on stocks with big discounts from sound or stabilizing book value as listed in our June 9 RTR. We reviewed two then, PNB Mtg. & Realty, now up 1 point to 10-5/8 on the NYSE, and ICM Realty, virtually unchanged at 8-5/8 on the ASE.

Three other deep-discount candidates are reviewed this issue.

MAJOR BLOCK PURCHASERS OF REALTY TRUST SHARES - 1978

Trust	Sh. Out (Th.)	Buyer(s)	Report Date#	Shares Owned(Th.)	% of Total	Market Value*
Atlanta Nat. R.E...	1,273T	Reed Rubin, Lee Balter et al	4/4/78	213.1T	16.7%	\$1,066T
Builders Inv. Gr...	2,929	Morse F. Van Horn et al	6/30/78	191.3	6.5	478
Citizens Growth...	811	Brent D. Baird et al	4/10/78	150.0	18.5	563
Fidelco Growth...	1,580	Asset Management Co.	2/14/78	67.0	4.2	184
" "	1,580	Wm. R. Wister Jr. et al	4/28/78	99.0	6.3	272
Hospital Mtg. Gr...	1,178	Transco Realty Trust	4/28/78	183.4	15.6	1,880
Kentucky Property	1,100	Brent D. Baird et al	4/3/78	170.8	15.5	427
Lincoln Mtg. Inv...	1,155	Ted Nelson, Dan. Montano et al	3/31/78	108.4	9.4	258
" " "	1,155	Morse F. Van Horn et al	7/6/78	74.4	6.4	177
Maryland Realty...	760	Federated Reinsurance Corp.	4/5/78	143.0	18.8	536
Midland Mtg. Inv...	2,382	E. Peter Hoffman Jr.	7/14/78	313.5	13.2	627
Miller (Hen.S.)...	560	James Jackson et al	5/5/78	63.8	11.4	862
Pennsylvania REIT	1,516	DeRance, Inc., Milwaukee	7/10/78	95.9	6.3	1,486
Texas First Mtg...	1,055	Brent D. Baird et al	4/14/78	76.7	7.3	278
Transco Realty Tr.	476	Lee Gray	4/13/78	92.0	19.3	E276
U.S. Bancorp R&M...	840	Merritt W. Truax	2/27/78	56.1a	6.7	715

Date of latest report, either on Form 13-D to S.E.C., to securities exchanges, or proxy. * Thousands of dollars as of 8/8/78. a-Trustees' holdings.

MERGERS/ACQUISITIONS: NATIONWIDE REAL ESTATE, MISSION INVESTMENT PONDER PROPOSALS

The marger/acquisition pot is boiling again -- in public.

The pot hasn't cooled much in private over the past three years. But it's been all private talk and no action because very few investors have the combination of cash and finesse and venturesomeness to create deals firm enough for public disclosure.

Now two prospective merger deals are out in the public eye -- along with a possible major property purchase. The trio:

Nationwide Real Estate Investors has promised an answer by Aug. 21 on a proposal by bank holding company Old Stone Corp. to offer \$17 of a new 9% preferred stock for all shares of Nationwide.

Mission Investment Trust is investigating an outline proposal that it issue about 7.25 million new shares to acquire Leroy Properties & Development Corp. of Las Vegas. If Mission goes along, Leroy would wind up owning 80% of Mission.

And Federal Realty Investment Trust has signed a purchase agreement to buy 15 shopping centers from Amterre Development, Inc. for about \$40 million. The centers have 2 million square feet of leasable space and the deal, if it goes through, would double Federal's assets.

Nationwide (14½ bid OTC) announced in April that it would consider either merger/acquisition or liquidation proposals (RTR, April 14) and subsequently talked to a great many prospective partners.

Old Stone Corp., Providence, R.I. bank holding company with \$1.1 billion assets, came forward with a conditional offer to issue 1,046,914 shares of a new Series B 9% preferred with \$17 stated value on a share-for-share basis for Nationwide.

This is the offer Nationwide is now mulling. If it accepts the conditional offer, a definitive merger agreement will be drawn up and circulated for regulatory and

shareholder approval.

Nationwide reserves the right to terminate if better offers are received but so far hasn't received anything higher. Its stated book value is \$24.36/sh.

Old Stone is no stranger to the REIT business.

It sponsored Old Stone Mortgage & Realty Trust in the boom times of the early 1970s and in May 1977 acquired all the trust's shares after the trust's earnings had declined.

This remains the only absorbtion of a REIT by a bank holding company to win Federal Reserve Board approval.

Old Stone Corp. then exchanged a 7% convertible preferred for the REIT shares.

Mission Investment said it received a letter, following a cursory talk, from Leroy Properties & Development of Las Vegas proposing that Mission issue enough shares to acquire Leroy giving it 80% of Mission. Leroy owns 19 apartment projects with 3,295 dwelling units in Las Vegas, plus some commercial properties. It is enjoying a surge of profits as it sells out a 204-unit high-rise condominium in Beverly Hills, Cal.

Leroy President Leo R. Frey and his brother are reported to own about 81% of Leroy's publicly traded shares.

Mission is investigating before responding.

Federal Realty agreed to pay \$40 million for a package of 15 shopping centers, most in the greater Philadelphia and New Jersey areas. Federal would pay about \$7-8 million cash over mortgages and leaseholds, probably funding with short-term debt.

The seller, Amterre Development of Bala Cynwyd, Pa. has decided to liquidate and sell its over 60 shopping centers.

ACTIVE STOCKS: BAY COLONY PROPERTY UP SHARPLY ON TAKEOVER AND GAMBLING RUMORS

Bay Colony Property has moved up nearly 50% to 4½ (NYSE) in heavy trading.

Wall Street sources say there's a takeover in the wind, although nothing has surfaced publicly and no confirmation from the trust.

More logical is belief that traders, straining for the next gambling stock play, are buying in hopes that BAY's Carriage House hotel in Miami Beach, acquired in exercise of remedies, will benefit if Florida voters approve gambling there.

We understand a proposal to legalize gambling only on the ocean side of Miami Beach north to the Diplomat in Hollywood will go on the Florida ballot in November.

Statewide sentiment now seems against the measure.

BAY has about \$22 million invested in Carriage House, subject to \$12 million first mortgage debt. That's about 11½% of invested assets. Hotel has been breakeven at best.

MORTGAGE GROWTH INVESTORS (7½--ASE-MTG) FY Nov. 30

Real estate investments: Holdings were \$45 million on May 31, little changed in size over the years. This trust, one of the earliest to stop commitments in 1973, has instead concentrated on revamping primarily through foreclosure and development. Initially a long-term lender, makeup is now 73% property. And this is meaningful in terms of income producing real estate, most is decent, even though the bulk was acquired by foreclosure. Portfolio mix at yearend Nov., 1977 was 61% apartments, 26% offices, 7% land loans and 5% shopping centers. Heaviest concentration was 34% California and 20% Louisiana.

The non-earning segment was worked down to three problems and all are in process of solution. The biggest was the \$1.3 million second mortgage on a New York office,

where MTG was also responsible for a \$4.4 million first to protect its position. This contentious situation was finally resolved with the trust to receive almost \$1 million cash and suffer a loss of a few hundred thousand dollars. There is \$1.9 million tied up in Maryland land which is now going to move. It is being developed by a joint venture. After downzoning to townhouses and lifting of a sewer moratorium, phased development is starting. It will take 2-2½ years to finish selling but the market is good and the parcel valuable. The total investment should be recovered with some interest. The only other remaining problem is \$1.4 million in partnership interests which are low earning. These are being restructured to provide a market yield. Thus effectively speaking the trust is looking at no meaningful problems.

The portfolio's core of property and mortgages is doing quite well. The \$11.5 million wrap-around on apartments in San Bruno, Cal. provides a market rate which the underlying property is more than covering plus building up unpaid interest which will be paid at maturity. The \$8.3 million apartments in Metairie, La. are doing so well that the trust recently was able to mortgage them for \$7 million. The Beechwood apartment project in Harrison Township, Mich., where \$3.9 million is already invested, is renting strongly so adjoining land is being developed with the second and third phases. Half the second phase for 88 units is complete and nearly all committed. With the market absorbing about 25 units monthly, the third phase for 104 units is being developed with contractors. Development is within bounds of renting progress. This good looking project has condo conversion potential if desired. A \$2.2 million land leaseback on a downtown Los Angeles office is earning. It is near the prestigious Arco building. The \$500,000 Miami, Fla. leaseback is well secured with participation.

Loss reserve: There was \$1.2 million in the loss reserve on May 31 or 2.6% of the portfolio. It is being reduced by the amount of the New York office loss. While it appeared thin before resolution of this problem, the reserve now looks more than adequate given the basically healthy nature of remaining holdings.

Financing: Total debt of \$18 million was 0.8 times equity of \$28 million on May 31. Debt was 57% secured mortgages and 43% convertible notes, 7-3/4% due 1986, institutionally held. Leverage is still modest, one of the trust's long-standing strengths, with the increased debt the secured mortgage variety, appropriate for a property trust.

Management & REIT status: Originally sponsored by Sonnenblick-Goldman, one of the largest mortgage bankers and New York real estate broker, MTG has been advised since FY 1977 by Manchester Advisory Corp., owned by principals of S-G. Trust has qualified as a REIT since 1971.

Recent results & outlook: Earnings were 12¢/share in the May quarter reflecting continued recovery. The dividend was raised the past two quarters, the latest 15¢. Payout can exceed reported earnings because depreciation has run about 8¢ quarterly making for gross cash flow of 20¢ last quarter.

Earnings appear in a strong recovery phase and significant further improvement is likely. The shares are attractive longer term. They sell 30% below depreciated book value of \$10.64, 36% below gross book of \$11.62. Current yield is 8%. This is very good value for this caliber situation where earning power should be running at a minimum annual rate of 60-65¢ by yearend. Additionally, there is financial room for portfolio growth when buying opportunities arise.

BAIRD & WARNER MORTGAGE AND REALTY INVESTORS (7½-OTC-BAIDS) FY July 31

Real estate investments: Holdings have been increasing since bottoming out in early 1977. On April 30, the \$46 million portfolio was 54% short-term mortgages and

41% acquired properties. Geographic emphasis remains in and around the Chicago area with a little being done in neighboring states. Both mortgage lending and property purchases should continue and build up these accounts in the next 6-12 months. Lending is active under the sponsor's important Chicago position as one of the leading commercial mortgage bankers. Recent deals include a \$2.5 million construction loan for a medical condominium in Illinois, a \$1.24 million construction loan for a 69,000 sf industrial building outside Chicago, and \$950,000 for a condo conversion in Arlington, Ill. Lendings should exceed loan paybacks by modest amounts the next few quarters. The property category grew \$4 million the past two quarters. Deals can not be timed but the trust is striving to build its property account to over half of assets.

The non-earning portion has been trimmed to 22% but more impressive is the underlying progress beyond the numbers. Even though the problem percentage is down from 37% two years ago, little has shown up in the bottom line. Now, however, the problems are winding down under good control although some remnants will still take a while. The \$10.4 million problems consist of \$8 million mortgages and \$2.5 million foreclosures. The biggest chunk in non-earning loans are an apartment in a west Chicago suburb and a renovated office building in downtown Chicago which together total \$4.7 million. Both are substantially leased. The apartment is in a strong growth area and is good value behind the loan. Being handled by a receiver, the trust is trying to get title but will accept a good price in receivership. It would make a good permanent holding. The office will take longer but is less than \$1 million. Chicago office space has dwindled but new space coming in a year could siphon from secondary structures like this. There are \$1.4 million in condo loans which should liquidate in a reasonable time, half within a year. Land loans of \$1.8 million, already down a little, will still take a few years. But in modest size pieces, the five parcels are moving fast.

Foreclosures total \$2.5 million, never having gotten large. Most is land. There is a \$1.2 million single-family tract outside Memphis which they have started developing. A big piece which will take time, it will be worked off at a good return. The \$500,000 Washington, D.C. tract has been under sales contract and will go soon. They will get the reserved price. The rest are condos moving with the improved market.

The \$19 million property portfolio is doing better. Rents rose a bit and strong demand for properties in the area should permit increases. High points are the Rain-tree apartments, \$8 million, on the verge of significant profit in a couple of quarters.

Loss reserve: The trust has \$3 million in its loss reserve, 6½% of total portfolio and 11% of mortgages plus foreclosures. While below the 13% industry average, this would appear adequate in view of limited problems. Surprisingly, however, additions were required: \$640,000, 61¢/share, in Jan. and \$50,000, 5¢/sh., in April.

Financing: Total debt of \$26.6 million is 1.6 times \$17 million equity, a fairly conservative ratio considering the partial property nature of holdings. Debt broke down 53% short-term, 32% secured mortgages and 15% convertible debentures. The \$14 million short-term bank borrowings are against \$24 bank lines at prime plus compensating balances of 15% or 10% of the line plus 10% of borrowings.

Recent results & outlook: In the April quarter, an 8¢/share loss was incurred after a 5¢ loss provision. Operations should approach and pass breakeven in the next few quarters. The drag of non-earning assets has not been reduced to the point of showing up in earnings. But the resolution and diminution of the problems is closer and daylight appears near. Moreover, new earning assets are becoming more significant.

The dividend situation is up in the air with payouts in recent years coming from the prior years' taxable income. So the trust paid 3½¢ quarterly the last four quarters and 24¢ the four quarters before that even though losses were reported. Near term declarations will depend on the audit of July FY when completed in Sept. The shares sell 53% below book value which has stabilized. The market price could therefore recover part of that discount when reportable earnings materialize and dividends are paid on a clearly sustainable basis. In a year or so, after problems are more fully resolved, earning power should be more than enough to justify current prices.

SUTRO MORTGAGE INVESTMENT TRUST (9-7/8--NYSE-SUT) FY Mar. 31

Real estate investments: The portfolio recovered to \$63 million on June 30 after bottoming out at \$60 million in late 1977, little more than half the peak \$116 million in March 1974. One of the healthy mortgage construction lenders, new commitments were initiated in late 1976 which have been funding sufficiently of late to overcome paybacks and sales of foreclosures. Thus short-term loans out climbed \$6 million in the past two quarters.

Recent commitments and lending by California-based Sutro represent geographical departure to obtain regional diversification. Major Western cities are being stressed: Minneapolis-St. Paul, Denver, Phoenix, Tucson, Dallas-Ft. Worth, Portland and Seattle. Any single city outside California will be limited to \$5 million. Standard property types are being strictly stressed: industrial, small office buildings and shopping centers and some apartments where economically feasible. The present makeup (including commitments) is concentrated 32% office, 23% industrial and 15% motel/hotel. Hereafter, types like motels will not be done because the specialized requirements are beyond the sponsor's real estate expertise. Long-term loans rose \$4 million last quarter as mortgages were taken back to facilitate two sales. The lending format will continue including 3-5 year terms which enable build out and permanent financing to be obtained. As a practical matter, most borrowers exercise their option to repay in less time.

Foreclosures continue to be whittled down. Reduced \$8 million in the June quarter to \$13 million, eliminations will be essentially completed by the end of fiscal 1979. The main lingering holding will be the \$4 million participation in Blue Hill office building in a New York suburb. Still only 18% occupied, resolution remains up in the air. The rest is moving well. The hotel in Sparks-Reno, Nev., \$4.2 million, is close to sale with no trouble. The \$3.5 million hotel in Colorado is being sold at reserved value. There is \$848,000 in an Atlanta office building on which offers to date are unsatisfactory but the market is improving.

The only other problem is a \$3.25 million non-earning loan on an apartment/marina in Oxnard, Cal. SUT is trying to foreclose but the property is under Chapter XII bankruptcy. It is well occupied and earning the stated interest but tied up legally. The latest step in this legal hassle was Sutro's petition for receivership trustee. It's just a matter of time though before the investment and some back interest, unaccrued, are gotten back from this valuable property.

Loss reserve: The \$3.85 million loss reserve is 6% of the portfolio but with problems well cleaned up and defined, this looks adequate even assuming pretty full washout on Blue Hill.

Financing: Debt of \$25 million is 0.7 times equity of \$36 million. Debt consists 15% short-term bank loans and 85% convertible debentures. Borrowings are under a \$38 million credit agreement at 3/8% over prime rate with 10% compensating balances of the line plus 10% of borrowings. The adviser provides most balances. One debenture, the \$17 million 6-3/4s, is due in 1982 when the trust expects to refinance them.

Management & REIT status: The trust is sponsored by Ralph Sutro Co., one of California's largest mortgage bankers. The trust has qualified as a REIT since founding.

Recent results & outlook: In the June quarter, 12¢/share was earned from operations and 15¢ from real estate sales. Operating earnings have slowly improved and this trend will continue the next few quarters as more non-earning assets are disposed and significant new earning loans are added. Even with foreclosure sales, the portfolio may grow \$5-7 million in the second half of fiscal 1979. Full year net should top \$1 including sales gains and operating earning power of 20-22¢ quarterly seems at hand. Thus while dividends include some capital gains, the 22½¢ quarterly rate looks sustainable. The shares sell 38% below stabilized book value of \$15.43, a little steep for this caliber situation and the current yield of 9.3% looks about right. There is some longer term potential, however, that more of former earning power can be reestablished. The convertible debentures provide reasonable current yields.